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John P. Gerni
Regional Vice President, State Relations
(260) 625-5386 t (202) 572-4764 f
johngerni@acli.com

STATEMENT OF AMERICAN COUNCIL OF LIFE INSURERS
JOHN P. GERNI, REGIONAL VICE PRESIDENT
BEFORE THE MICHIGAN HOUSE INSURANCE COMMITTEE
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Good morning, Chair Byrum and members of the Committee. Thank you for inviting me to discuss concerns regarding Stranger Originated Life Insurance (STOLI) and its abusive practices to seniors.

Life Insurance has for centuries been respected as a valuable financial instrument, protecting families and businesses from the financial devastation caused by untimely death. Responsible productive members of society, with dependents who would be faced with economic hardship if they die unexpectedly, need life insurance in order to minimize that risk. While there are some useful benefits of life settlements, I'd like to focus on a subset of life settlements that puts in force a life insurance policy for the sole purpose of ultimately transferring the death benefits to the investment market. This Stranger Originated Life Insurance, known as STOLI is designed to provide profits to investors and the intermediaries who conduct such business. State law requires and public policy necessitates that there be an "insurable interest" in the continued life of the insured for the lawful contracting of life insurance. STOLI, however, flips that on its head, and the speculators of the policies have an interest only in the death of the insured, with the highest return directly tied to early deaths.

Let me take a moment to describe how these transactions work:

An agent approaches a senior offering a large life insurance policy, with "free insurance" for 2 years, and usually accompanied by other financial incentives such as cash or free trips.

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101 Constitution Avenue, NW, Washington, DC 20001-2133
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- **A life expectancy evaluation is arranged so that the investment speculator can cherry pick those with the shortest life expectancy enabling them to arbitrage the average pricing assumptions of the insurer.**

- **Financing is arranged to pay the premiums, with a promise of no cost to the senior.**

- **A trust, sub-trust or other increasingly obscure entity is created to hold the ownership and beneficiary interests in order to mask the true intent of the deal.**

- **At the end of the 24 month contestability period, the senior can repay the loan (several hundred thousand dollars in premiums, plus top-of-the-market interest rates) or sign over the policy as full repayment for the loan. It is expected that the policy will be signed over at this point. In fact the financing is usually only provided for 2 to 3 three years. Two years is a critical point, as the insurance company is generally prohibited from voiding the coverage on the basis of misrepresentation on the application after two years. Thus, most transfers occur after this period so that the investor has no risk of the policy being rescinded.**

- **The policy is then packaged into a "death bond" and sold to investors. As part of the scheme, the senior agreed to calls/visits every three months to monitor their life status, and if death is anticipated within a year, these "grim reaper" calls may be as frequent as monthly. One can only imagine how a senior citizen is made to feel when those calls come in.**

- **Concerned regulators, insurers and agent organizations have been advocating for enactment of state laws to prohibit these transactions for the past few years. The question most frequently asked by state policy-makers is "Who's the Victim?" Actually, all of society pays a price, and I would like to quickly run through some of the costs of STOLI schemes.**

- **The insured senior, perhaps unintentionally, is usually participating in a fraud.**

- In a STOLI deal, the senior may be responsible for undisclosed taxes on the economic value of the "free coverage" as well as the value of the discharge of indebtedness when the loan is repaid and any other incentives paid to them.

- Also, there is no guarantee that investors will buy the policy, since there are stories that with money so tight today, some seniors are now stuck with repaying the loan.

- The senior may be ineligible for future life insurance when needed, as the investors are holding all the coverage for which the senior will qualify.

- Seniors personal information, including medical records, may be shared with entities not subject to state and federal privacy laws.

- Insurance companies may find it necessary to restrict offering life insurance to the senior market and may be forced to raise prices for all applicants due to losses it is likely to suffer on these fraudulent sales.

- But investors may also come up short finding that they hold a worthless security, if the policy is rescinded for violation of insurance law or fraud or if the insured lives a longer than anticipated life. Many of these "death bonds" are in pension portfolios, adding further risks for seniors and all American consumers if they do not perform.

- And, the financial markets may be exposed to yet another subprime securitization scheme – similar to sub-prime mortgages where the ongoing premium required to fund the insurance is more than the investors can or wish to fund if the insured continues to live.

Both the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL) have adopted Model Acts to prevent STOLI. In 2008, 12 states adopted meaningful laws, 4 states have acted this year, and bills are pending in about another 14 states. We commend Rep. Byrum for her interest in introducing legislation that would incorporate the key anti-STOLI provisions from both models, which would allow Michigan to have one of the strongest anti-STOLI laws in the country.

However, these models have faced strong opposition from the settlement providers, premium financing companies and investors in the state debates. The decision-makers are continually told that no settlement company is originating life insurance for investors. Yet many investigations and court cases have provided contradictory evidence.

- For example, an insurer found an applicant from California who signed financial statements justifying a multimillion dollar policy while they were receiving Medicaid. She had been approached in an Assisted Living Facility and clearly did not financially qualify for this large policy.

- Last year, just after Ohio passed a law prohibiting STOLI, where a 74 year old woman was driven from her home in Cleveland to Pittsburgh for a medical exam and to sign an insurance application. When interviewed, she was shocked to learn that the death benefit of the policy was $9 million. She and her husband have a monthly income of $950 from social security and their net worth is $2,000. After understanding what had transpired, the woman became very concerned for her safety.

Also, a recent study found that half the policies settled in 2008 were settled less than 5 years from the issue date. One has to ask, is it really possible that these policies were purchased with a valid insurance need and are no longer needed less than 5 years later? And over a third of the settlements were between years 2 and 3 years from issue, just outside the contestability period. Rep. Byrum's legislation addresses this very issue by prohibiting the settlement of policies within five years, yet this restriction would only apply to policies 1) where the insured has undergone a life expectancy evaluation for purposes of settlement, 2) if the insured utilized non-recourse financing; or 3) if the insured has entered into a life settlement agreement. An insured may also settle the policy in the event of extenuating circumstances such as the death of a spouse, retirement, divorce, terminal or chronic illness, disability, or bankruptcy.

STOLI is yet one more example of where the middlemen make their commission right up front on a financial transaction of little intrinsic value. Our country is already experiencing the negative consequences of misplaced incentives and lack of regulation in the mortgage broker business. Settlement brokers participating in STOLI make a commission from the initial life policy sale and may make another from the settlement transaction. And, as the securitized package is sold and resold, additional commissions are paid to middlemen. There is every incentive to "do the deal" and little concern for the impact of the deal on all the other parties, or whether the deal has genuine value to the elderly consumer.

Insurers design and price their policies using average assumptions as to probability of death, surrender and lapse for large blocks of business. Inside these large blocks of policies some insured's will die early and some will live long. Those that die early will be judged to receive a high return on their premium. Conversely, those who are fortunate enough to live a long life will be viewed to receive lower yield, since a portion of their premiums will have been used to pay for the early deaths of others. But it is a win for those who enjoy long life, as they will have enjoyed having the peace of mind knowing that their families or businesses were protected. And insurers, whose block of policies perform in the expected manner, also benefit. So, it is a win/win for all. This is how insurance works.

That is not the case with STOLI – as STOLI is wagering – so there must be a winner and a loser. The investors expect an average return by buying policies on the lives of selected insurers who they expect will die earlier than others in the risk pool. The assumptions that go into the insurer's product designs, underwriting, investments and pricing are arbitraged, and in some cases these values are significantly enhanced by way of fraud. If the death benefits exceed the costs the investors win, and the insurers lose. As I stated earlier, winning is enhanced by early deaths, a principle contrary to our value system of preserving life.

It is for these reasons that the life insurance industry is working hard to get legislation passed in each and every state to prohibit all forms of STOLI and to ensure that the life insurance continues to be available, on an appropriate and affordable basis.

Thank you for the opportunity to testify today. I hope the testimony provided you with the appropriate information so that you can support Rep. Byrum's legislation which would help curb this abusive practice which is a threat to all residents and certainly seniors.